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In the Supreme Court of the United States

OCTOBER TERM, 1975

UNITED STATES OF AMERICA, PETITIONER

v.

FOSTER LUMBER COMPANY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. Stripped to its essentials, respondent's position in this case is that it can "carry back" a $42,000 loss incurred in 1968 to offset its 1966 taxable income of $174,000, and after that offset nevertheless continue to have $35,000 of its loss left over for use as a "carryover" to offset 1967 income. The mathematical impossibility of its argument that any part of a smaller loss figure would be available after its offset against a larger taxable income figure is made further apparent by the explicit terms of Section 172(b)(2) of the Code, which govern this case. Pursuant to that provision, the amount of a loss carryover in these

circumstances is "the excess, if any, of the amount of such loss [$42,000] over the sum of the taxable income [$174,000] for each of the prior taxable years to which such loss may be carried." After this statutorily prescribed computation, there can be no part of the loss remaining for further offset against the taxable income of other years, because there was no "excess" of the loss over the taxable income for the first year to which the loss was carried back.

Faced with this formidable statutory obstacle, respondent and the *amicus* Data Products Corporation [1] rest their argument primarily on the basis of what they perceive to be the legislative policy underlying the loss carryover provisions. In conformity with the decision below (Pet. App. B 13a), they assume that the loss carryover provisions were intended to establish a fluid system that would at all events maximize tax savings by eliminating completely the consequences of timing necessarily incident to the annual accounting system. Cf. *Burnet* v. *Sanford and Brooks, Co.*, 282 U.S. 359.[2]

[1] Unless otherwise indicated, "*amicus*" refers to Data Products Corporation.

[2] The *amicus* argues its case by the use of an unwarranted and inaccurate terminology of its own devising. In the Question Presented (Br. 2), the Summary of Argument (Br. 3) and the Argument (Br. 8 and *passim*), it refers to a "business loss" for 1968 being used as a deduction against, or to reduce the tax on, "business income." However, this usage is not employed by the Internal Revenue Code. The Code does not prescribe the nature and components of the net operating loss allowed to a corporation in terms of "business loss." Section 172(c) defines "net operating loss" simply as "the excess of the deductions allowed by this chapter over the gross income." Those deductions for respondent or any other corporate taxpayer claiming a net operating loss deduction may consist wholly or partially of such non-business items as worthless non-business loans (Section 166), deductions for non-business losses (Section 165), taxes on non-business property or transactions, or interest paid on non-business loans or obligations (Section 163).

Moreover, the net operating loss deduction (Section 172(a)) is not a deduction from "business income," but a deduction from gross income defined in Section 61(a), to arrive at the taxable income, defined in Section 63(a), which is both the base on which the tax is imposed and the base by which it is determined whether there is a net operating loss to be carried to any year after the earliest year to which it may be carried (Section 172(b)(2)). There can be no doubt that capital gains do not constitute a separate category, but are included in gross income and taxable income. See Section 61(a)(3) and *Helvering* v. *Bliss*, 293 U.S. 144. Indeed, even if the category has relevance, "business income" would include many capital gains. See Sections 1221 and 1231.

The decisions of this Court demonstrate the error of respondent's assumption that the loss carryover provisions were designed to eliminate all consequences of the timing of a loss. Each time the Court has considered claims that the loss carryover provisions applied to a given situation, it has rejected generalities couched in broad policy terms but has instead looked to whether there was explicit statutory support for the taxpayer's position. See 5 Mertens, *Law of Federal Income Taxation* (Rev.), Section 29.02. Thus, for example, in *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 326, the Court stated: "A taxpayer who seeks an allowance for losses suffered in an earlier year, must be able to point to a specific provision of the statute permitting the deduction, and must bring himself within its terms.

Unless he can do this, the operations of the current year must be the measure of his burden." Similarly, in *Lewyt Corp.* v. *Commissioner,* 349 U.S. 237, 242, the Court stated: "It is true that the computations under § 122 are designed to spread losses over a five-year period. But we are concerned with a technical concept that is being used as the basis of the formula for that reallocation." See also *United States* v. *Olympic Radio and Television,* 349 U.S. 232, 234, 235. Indeed, in *Reo Motors* v. *Commissioner,* 338 U.S. 442, 446–447, relied upon by the *amicus* (Br. 22), the Court's denial of the net operating loss deduction turned on the timing of the taxpayer's loss.

Moreover, the familiar observation in *Libson Shops, Inc.* v. *Koehler,* 353 U.S. 382, quoted by respondent (Br. 19–20) and the *amicus* (Br. 21), as well as in our opening brief (pp. 12–13), does not buttress their argument that the consequences of the timing of a loss have been eliminated by Section 172. There, the Court stated that the operating loss carryover and carryback provisions "were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year" (353 U.S. at 386). This statement, however, would not even offer general support for respondent's argument without the substitution of the word "eliminate" for "ameliorate" and the omission of the qualifying

term "something like" preceding the phrase "an average taxable income * * *."

It is therefore clear that questions arising under the loss carryover provisions cannot be resolved on the basis of unsupported notions of policy but depend upon the terms of the statute. Thus, contrary to the *amicus'* argument (Br. 33), the fact that a different result would follow if the sequence of respondent's taxable years 1966 and 1967 had been inverted does not cast doubt upon the correctness of the government's position. We do not dispute that Section 172 gives significance to the timing of income and losses. But in reducing the impact of the annual accounting system, Congress was surely free to impose whatever modified timing requirements it deemed to be appropriate as a condition for the deduction of losses of one year against the income of another.

As this Court recently observed in *Commissioner* v. *Nat. Alfalfa Dehydrating,* 417 U.S. 134, 148–149, "The propriety of a deduction does not turn upon general equitable considerations, such as a demonstration of effective economic and practical equivalence. Rather, it 'depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.' *New Colonial Ice Co.* v. *Helvering,* 292 U.S. 435, 440 (1934); *Deputy* v. *DuPont,* 308 U.S. 488, 493 (1940)." See also *Central Tablet Mfg. Co.* v. *United States,* 417 U.S. 673, 690. As a result, the various examples invoked by the *amicus* (Br. 32–38) to illustrate the tax consequences of what might have

occurred under different chronological sequences are beside the point.

At all events, respondent cannot escape the fact that timing is significant even under its own position. Respondent (Br. 25–26) and the *amicus* (Br. 47) acknowledge, as indeed they must, that had respondent realized its 1966 and 1967 capital gains in 1968, it would have had an operating loss to carry to any year, and its aggregate tax would have been the same as was the sum of its taxes for 1966 and 1967 [3] (see our opening brief, pp. 28–33). Economic equivalence, therefore, is no substitute for application of the precise terms of Section 172(b)(2) to the facts of this case. Under that provision, respondent's loss must be offset against all of its "taxable income" for 1966, *i.e.*, its ordinary income and capital gains.[4]

[3] Respondent (Br. 27) and the *amicus* (Br. 19) acknowledge the correctness of the argument in our opening brief (pp. 17–23) that the meaning of "taxable income" in Section 172(b)(2) is the same as in Section 63(a), the definitional provision. However, another *amicus*, North River Insurance Company, questions that conclusion. In support of its contention, it relies upon *Merrill* v. *United States*, 105 F. Supp. 379 (Ct. Cl.). That case is distinguishable. There, the court construed the then applicable tax limitation of Section 12(g) of the 1939 Code, and held that its limitation that the tax shall not exceed 90 percent of the "net income" of individuals operated without regard to capital gains, if the Section 117(c)(2) alternative tax were applicable. However, in so concluding, the court specifically stated that its decision turned on the particularized provisions of the alternative tax which imposed a tax in lieu of the regular tax and did not constitute a deviation from the well-accepted meaning of "net income" established by this Court in *Helvering* v. *Bliss*, 293 U.S. 144, and *Pleasants* v. *United States*, 305 U.S. 357 (see 105 F. Supp. at 383).

[4] *Lone Manor Farms, Inc.* v. *Commissioner*, 61 T.C. 436, described in our opening brief (p. 33, n. 22), further illustrates that respondent's position does not eliminate the effects of timing.

2. Contrary to respondent's and the *amicus'* argument, nothing in the legislative history of Section 172 and its predecessor provisions demonstrates that Congress intended to adopt the policy of eliminating entirely the consequences of the timing of a loss. The materials to which respondent refers (Br. 18–19, 43–47) reveal the undisputed and irrelevant fact that Congress has enlarged the span of years within which a loss may be carried. Similarly, the Commitee Reports invoked by the *amicus* (Br. 21–32) speak only of the desirable goal of reducing the impact of the annual accounting system by means of the net operating loss deduction. They do not, however, discuss any of the limitations imposed by Congress on that deduction.

Although the Committee Reports do not offer any affirmative evidence of a congressional intention to eliminate considerations of timing, one aspect of the statutory history bears on the proper resolution of this case. An examination of the immediate predecessor to Section 172(b)(2)—Section 122(b)(2)(A) of the 1939 Code [5]—demonstrates that respondent's position could not have been sustained under the 1939 Code. As it existed after amendment by the Revenue Act of 1950, c. 994, 64 Stat. 906, 937, Section 122(b)(2)(A) of the 1939 Code provided, in relevant part, as follows: "* * * the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over

[5] Section 122(b)(2)(A) related to carry-overs. Section 122(b)(1)(A), relating to carry-backs, is phrased in the same fashion.

the net income for the intervening taxable year * * *." The term "taxable income" is used in the 1954 Code where "net income" was used in the 1939 Code.

It would therefore be impossible to reach the result for which respondent and the *amicus* contend under the 1939 Code because the phrase upon which they necessarily depend—"to which such loss may be carried"—is absent from that earlier provision (see our opening brief, p. 25, n. 17). Because the 1954 Code Committee Reports indicate that no substantive change was intended by the redrafting that produced Section 172(b)(2),[6] the result under the 1954 Code would be the same as under the 1939 Code. In both cases, there would be no excess of the 1968 loss over 1966 income available for carryover to 1967.[7]

3. Respondent (Br. 10–11) and the *amicus* (Br. 11, 32) further argue that the government's position would tax respondent on a total of $396,000 for the three-year period, 1966–1968, although respondent's aggregate income for the period was $361,000. A careful analysis of the figures demonstrates that this statement is simply inaccurate.

[6] With respect to Section 172, the Committee Reports state: "The net operating loss provisions have been rewritten both for purposes of clarity and also to incorporate several major substantive changes." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A56 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 211 (1954). The substantive changes are thereafter discussed, but the provisions here in question do not appear among them.

[7] The *amicus* (Br. 43–45) argues that the Treasury Regulations offer no support for our position, and finds significance in that supposed fact. But the relevant Regulations, set forth at pp. 40–44 of the Appendix of our opening brief, are explicit in setting forth

Respondent had taxable income of approximately $174,000 in 1966 and $229,000 in 1967, and a net operating loss of $42,000 in 1968. This results in aggregate taxable income of $361,000 for the three-year period. On these figures all agree. When the 1968 net operating loss of $42,000 is carried back to 1966, respondent's taxable income for 1966 is reduced from $174,000 to $132,000. The tax on $132,000 taxable income for 1966, computed under Section 11 of the Code was (see our opening brief, p. 4) $58,200.52. Computing the tax *on the same $132,000 of taxable income,* but by the alternative method provided in Section 1201, produced the lower tax of $41,658.70 that was the ultimate tax paid for 1966. As the Sixth Circuit pointed out in *Axelrod* v. *Commissioner,* 507 F. 2d 884, 887: "Taxable income is the same regard-

the position that we support. The court below and the respondent had no doubt of that. The court of appeals stated (Pet. App. B11a): "The taxpayer concedes that its interpretation of section 172(b)(2) is counter to the position announced in Treasury Regulation 1.172–4(b)(ii), but notes that court which has considered the issue has squarely rejected the position taken by IRS." Presumably the court below thought that, in deciding for the respondent, it was holding the Regulation invalid, though it did not specifically so state. Indeed, the Fourth Circuit in *Mutual Assurance Society of Virginia Corp.* v. *Commissioner*, 505 F. 2d 128, 138, n. 21, noted that the Regulation in question was "directly contrary to *Chartier Real Estate*, [and] has been in existence since, as well as before *Chartier Real Estate*." In *Chartier Real Estate* v. *Commissioner*, 52 T.C. 346, affirmed *per curian*, 428 F. 2d 474 (C.A. 1), the Tax Court upheld respondent's position in this case. Moreover, the Sixth Circuit in *Axelrod* v. *Commissioner*, 507 F. 2d 884, 888–889, concluded its opinion by approving the pertinent Regulations as a reasonable implementation of Section 172.

less of the method of computation even though the amount of tax due may be different."

With respondent's 1966 taxable income reduced to $132,000 because of the carryback of $42,000 from 1968, and with its 1967 taxable income of $229,000 remaining unchanged, the total taxable income for the three-year period under the government's method equals $361,000 and not $396,000 as respondent and the *amicus* state. Using the more favorable method of computation of the 1966 tax, as respondent properly did, hardly increases the amount of income that was taxed.

If we take this one step further, it becomes evident that respondent and the *amicus* would reduce the taxable income for the three-year period from the agreed $361,000 to $326,000. Respondent did in fact employ the $42,000 net operating loss for 1968 to reduce its taxable income for 1966 from $174,000 to $132,000, recomputed its tax on this basis, and that recomputation was uncontested. Now it seeks further to reduce its taxable income for 1967 by $35,000 from $229,000 to $194,000. If it were successful, it would be taxed not on the $361,000 of taxable income that respondent and the *amicus* acknowledge was its total taxable income for the three-year period, but only on $326,000. Thus, respondent's assertion that the government is attempting to tax more than its aggregate taxable income for the three-year period masks its own argument in support of a tax on an amount clearly less than its aggregate taxable income for the period.

4. In our opening brief (p. 26), we pointed out that the Tax Court's construction of Section 172(b)(2) in *Chartier Real Estate Co.* v. *Commissioner*, 52 T.C. 346, affirmed *per curiam*, 428 F. 2d 474 (C.A. 1), was contrary to the overall usage of the Code. Throughout Section 172, the term "carried" has a temporal connotation of a transfer of a loss from the year in which it occurred, and would normally be taken into account, to another year.[8] Respondent (Br. 28–32) and the *amicus* (Br. 15–21) argue that the term "carried" in the statutory phrase "to which such loss may be carried" modifies "taxable income" so that the destination of the loss is an amount, "taxable income", rather than, as we believe, a taxable year.

The source of the correct usage, however, is the Code and not the dictionary definition relating to the arithmetic usage relied upon by the *amicus* (Br. 20–21). In the text of Section 172, phrases such as "carried to," "carryover to," and "carryback to" occur thirty-four times. Significantly, in every case,[9] the

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[8] See *Commissioner* v. *Van Bergh*, 209 F. 2d 23, 25 (C.A. 2), where Judge Learned Hand explained: "The purpose of the 'carry-back,' or 'carry-over,' privilege is to allow a taxpayer some equivalent for the fact that he has not been able to reduce his tax by a loss, because he has had no income in that year against which to credit it; and the only practicable equivalent is by a fiction to treat the loss as a deduction from his income in an earlier, or a later, year."

[9] The phrases are: (1) Section 172(a): "carryovers to such year"; (2) "carrybacks to such year"; (3) Section 172(b)(1)(A)(i): "carryback to each of the 3 taxable years preceding"; (4) Section 172(b)(1)(A)(ii): "carryback to each of the 5 taxable years preceding"; (5) Section 172(b)(1)(B): "carryover to each

object of the preposition "to" is a specified year, or years, or a "which" that refers to a year or years.

Contrary to the *amicus*' argument (Br. 20), the usage of "carry" in Section 1212, dealing with capi-

of the 5 taxable years following"; (6) Section 172(b)(1)(C): "carryover to each of the 7 taxable years following"; (7) Section 172(b)(1)(D): "carryback to any taxable year preceding"; (8) "carryover to each of the 19 taxable years following"; (9) "or * * * to each of the 15 taxable years following"; (10) Section 172(b)(1)(E): "carryback to each of the 5 taxable years preceding"; (11) "carryover to each of the 3 taxable years following"; (12) Section 172(b)(1)(F): "carryback to each of the 10 taxable years preceding"; (13) "carryover to each of the 5 taxable years following"; (14) Section 172(b)(1)(G): "carryback to each of the 10 taxable years preceding"; (15) "carryover to each of the 5 taxable years following"; (16) Section 172(b)(2): "loss * * * shall be carried to the earliest of the taxable years"; (17) "loss which shall be carried to each of the other taxable years"; (We omit, and do not count, the phrase in Section 172(b)(2) that is central to this case: "the sum of the taxable income for each of the prior taxable years to which such loss may be carried"); (18) Section 172(e): "carryback or carryover to any taxable year"; (19) Section 172(f)(2): "loss * * * which shall be carried to the second preceding taxable year"; (20) "amount carried to any other taxable year"; (21) "loss which is carried to the second preceding taxable year"; (22) Section 172(g)(1): "taxable years * * * to which a net operating loss * * * may be carried"; (23) Section 172(g)(2)(A): "years * * * to which a net operating loss * * * may be carried"; (24) Section 172(g)(2)(B): "carryback to the first taxable year"; (25) "loss carried to such year"; (26) Section 172(g)(2)(B)(ii): "loss which * * * is carried to the second preceding taxable year"; (27) Section 172(i): "loss for such year which shall be carried to the third preceding taxable year"; (28) "amount carried to any other taxable year"; (29) Section 172(j)(3)(A): "carryover to the 6th taxable year following"; (30) Section 172(j)(3)(B): "carryover to the 7th taxable year following"; (31) Section 172(j)(4): "loss which may be carried—(A) to the 6th taxable year following"; (32) "amount which * * * would be

tal loss carrybacks and carryovers is exactly the same as in Section 172. In Section 1212, there are nine instances where the term "carry" is used.[10] In every case, the object of the preposition "to" is a specified year or years, or a "which" that refers to a year or years. Indeed, the two partial phrases in Section 1212 cited by the *amicus* (Br. 20) would, with more extended quotation than it has chosen to set forth in its brief, also demonstrate that "carry" relates to a transfer in time and not to an income item."[11]

5. Finally, the *amicus* (Br. 59–64) requests the Court, should it sustain the government's position, to examine and disapprove the rule of *Weil* v. *Commissioner*, 23 T.C. 424, affirmed, 229 F. 2d 593 (C.A. 6). That case held that an individual taxpayer could not, in the computation of the alternative tax, offset

carried to such 6th taxable year"; (33) "(B) to the 7th taxable year following"; (34) "amount carried to the 6th taxable year".

[10] The phrases are: (1) Section 1212(a)(1): "loss carryback to each of the 3 taxable years preceding"; (2) "loss carryover to each of the 5 taxable years"; (3) "loss for any taxable year shall be carried to the earliest of the taxable years"; (4) "loss which shall be carried to each of the other taxable years"; (5) "each of the prior taxable years to which such loss may be carried"; (6) "loss which cannot be carried back in full to a preceding taxable year"; (7) "loss which can be carried back to such preceding taxable year"; (8) Section 1212(a)(3): "loss of a corporation * * * shall not be carried back under paragraph (1)(A) to a taxable year for which"; (9) Section 1212(a)(4): "loss of a corporation shall not be carried back under paragraph (1)(A) to a taxable year".

[11] The phrases cited by the *amicus* are the sixth and seventh phrases referred to in n. 10, *supra*.

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in a single year an ordinary loss against capital gains which were subject to the flat 25 percent tax.[12] In this respect, the *amicus* disagrees with respondent's characterization (Br. 8) of *Weil* as "a long-established rule" which it does not challenge (Br. 36–38). But suffice it to say that the correctness of *Weil* was not contested by the parties in the courts below or decided by those courts. It is not an issue here. There is accordingly no occasion for this Court to issue the advisory opinion the *amicus* seeks concerning the correctness of *Weil*.

CONCLUSION

For the reasons stated above and in our opening brief, the judgment of the court of appeals should be reversed and remanded to the district court with directions to dismiss the complaint.

Respectfully submitted.

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[12] As we pointed out in our opening brief (pp. 30–31), the *Weil* rule was applied to corporations by the Tax Court in *Chartier Real Estate Co.* v. *Commissioner*, 52 T.C. 346, 350–356, affirmed *per curiam*, 428 F. 2d 474 (C.A. 1), the very case upon which respondent and the *amicus* rely for their construction of Section 172(b)(2).

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